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The Curious Case of the Indian Dividend Distribution Tax – Inverse Split-rates on Corporate Profits? Or a Source-agnostic Levy?

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In this blog, I shall examine the policy and characteristics underlying the split-rate system of taxing corporate profits/income. I shall also discuss the issue whether the Indian Dividend Distribution Tax (DDT) represents an inverse split-rate applied to corporate *profits/income*, or if it is merely an independent levy, which is source-agnostic.

Split-rates and their role in the avoidance of economic double taxation

A company, being a separate entity from its shareholders, is taxed on its income as a person. Dividends it pays may be taxed separately in their hands as a different stream of income. However, dividends are not considered to be a tax deductible expense, giving rise to what is known as *'economic double taxation'*, unless relief is provided in one of the six possible ways.[1] Split-rates can be used to relieve economic double taxation by imposing a reduced rate of tax on corporate profits distributed as dividends, as compared to those retained or accumulated.

Split-rates and their role in influencing economic behaviour

Split-rates could also be employed to incentivise certain behaviour, such as reinvestment, by firms, and consumption by shareholders. Germany, for example, used to adopt a three-tiered split-rate system where reinvested corporate profits were taxed at a lower rate than those paid out as dividends,[2] which, in turn, were taxed at a lower rate than profits accumulated. Clearly, this system was adopted to stimulate Germany's post-war economy by adding velocity to the Mark by incentivising reinvestment and consumption. This also disincentivised companies from accumulating profits, which would only reduce circulation of the currency.

Does the Dividend Distribution Tax represent an inverse split-rate system?

Speaking in Parliament on 28 February 1997, the then Indian finance minister stated:

> "Some companies distribute exorbitant dividends. Ideally, they should retain bulk of their profits and plough them into fresh investments. I intend to reward companies who invest in future growth."

However, rather than rewarding companies that reinvested their profits, the finance minister disincentivised the distribution of dividends. He introduced the Dividend Distribution Tax – an additional tax burden on companies that distributed their earnings to shareholders.

The motivations may seem strange to the modern reader, but the finance minister's choices can be understood in the context of the times. Perhaps unlike their (West) German counterparts, Indians were known to be thrifty consumers who would rather let money earned through dividends lie idle – saving for the rainy day – than spend towards consumption. Presumably the finance minister deemed companies to be a more likely source of reinvestment, lending velocity to the relatively lethargic Rupee. Economic double taxation was technically resolved by exempting dividends from tax in the hands of shareholders,[3] but the reality was that the tax burden was merely shifted to the company.

The interesting (and, for companies, crucial) question arises whether the DDT is a inverse split-rate on corporate *income*, or a source-agnostic tax. I shall examine this question below.

The issue does not arise should dividends be declared from a certain part of a company's profits. For example, an Indian company which has after-tax profits of 100 decides to distribute 40 as dividends. The DDT @ 15%[4] levied will be 0.15 x 40 = 6. This being an additional tax on the company, and not on the shareholders, the cash balance of the company would be 100 – 40 – 6 = 54. In this case it is clear that the tax liability can be met from undistributed profits.

However, would it be possible for the company to distribute all of its after-tax profits of 100 as dividends? In this scenario, it could be argued that a DDT of 15 would be levied on the company, which, given that there are no profits to be paid out, should be paid out of the company's capital.

If both the hypotheticals above were possible, then the DDT may be seen not an *income* tax on a company's *undistributed profits (current or accumulated)*, but rather a source-agnostic levy. Are there reasons why the DDT should nonetheless be regarded as an inverse split-rate on a company's *profits*?

It could be argued that it is highly unlikely that any company would distribute all its profits so as to allow the DDT to erode its capital. A scenario in which it may seem remotely practicable is if the company wishes to reduce its capital. But even in that case, it would be prudent and reduce its capital (by buying back shares), rather than pay dividends. This is because the buyback of shares in India results in capital gains (if any), and not dividends; the DDT is, therefore, not triggered. One could argue that, practically, the legislature could not have intended anything but a tax on undistributed profits.

This does not appear to be a very strong argument. The legislative history shows that the DDT was introduced in order to dissuade companies from distributing dividends. Such an end could be served whether or not the tax is on income or on capital. This might suggest that the legislature was indeed agnostic about the source from which the tax came.

Also, there might be at least one realistic scenario in which a company would have to distribute all its accumulated profits, notwithstanding the fact that the DDT would erode that company's capital. This would be in the case of liquidation of a company.

Distributions made upon liquidation of a company are considered to be dividends to the extent they are sourced from accumulated profits.[5] Assuming a company being liquidated has capital of 50 and accumulated profits of 100, it could be argued that the DDT liability of 15 could be met from the company's capital, buttressing the position that the DDT is a source-agnostic levy on a company.

However, this argument suffers from a fatal flaw. It is settled that law should be interpreted in a manner which can be applied harmoniously no matter what the facts are, so as to avoid absurd results in certain fact patterns. As demonstrated below, the notion that the DDT may be a source-agnostic tax may lead to absurd results in some cases.

It is not unusual for companies to have accumulated profits which are several times greater than its capital. For example, a company may have capital of 100 but accumulated profits of 1000. If this company were liquidated, the 100 of capital would not suffice to cover the DDT liability (150), which would arise if the entire 1000 of accumulated profits are considered to constitute a dividend payment.

The only manner in which the levy of DDT would not fail in such a case is if the DDT were treated as a tax on undistributed profits of the company, rather than a source-agnostic tax. Thus, the maximum possible dividend amount would be 1000 / 1.15 = 869.6, and 130.4 would be the DDT levy. This interpretation would ensure that the absurdity of a charge failing basic arithmetic (despite funds being available) does not arise.

To conclude, the DDT should be interpreted as representing an inverse split-rate system of taxing corporate *profits/income* at a higher rate when they are distributed, rather than when they are retained. They should not be construed as being source-agnostic levies.

(All views are personal.)

END NOTES

[1] Countries may adopt one of six approaches to relieve economic double taxation in varying degrees. Relief may be provided at the level of shareholders through participation exemptions, underlying tax credits, imputation credits, or special (flat) rates for shareholders. At the company level, relief could be provided through dividend deduction, or by applying split-rates.

[2] Germany used to apply the imputation system simultaneously with the split-rate system in case of corporate profits paid as dividends.

[3] This is no longer the case, as section 115BBDA, Income Tax Act, 1961 imposes a tax of 10% on individuals receiving dividend income in excess of 1 million Rupees. The tax is imposed only on the excess amount.

[4] The current rate of the DDT is 15%, but it is also subject to surcharge and cesses, which are ignored for the purposes of these hypotheticals.

[5] Section 2(22)(d), Income Tax Act, 1961.

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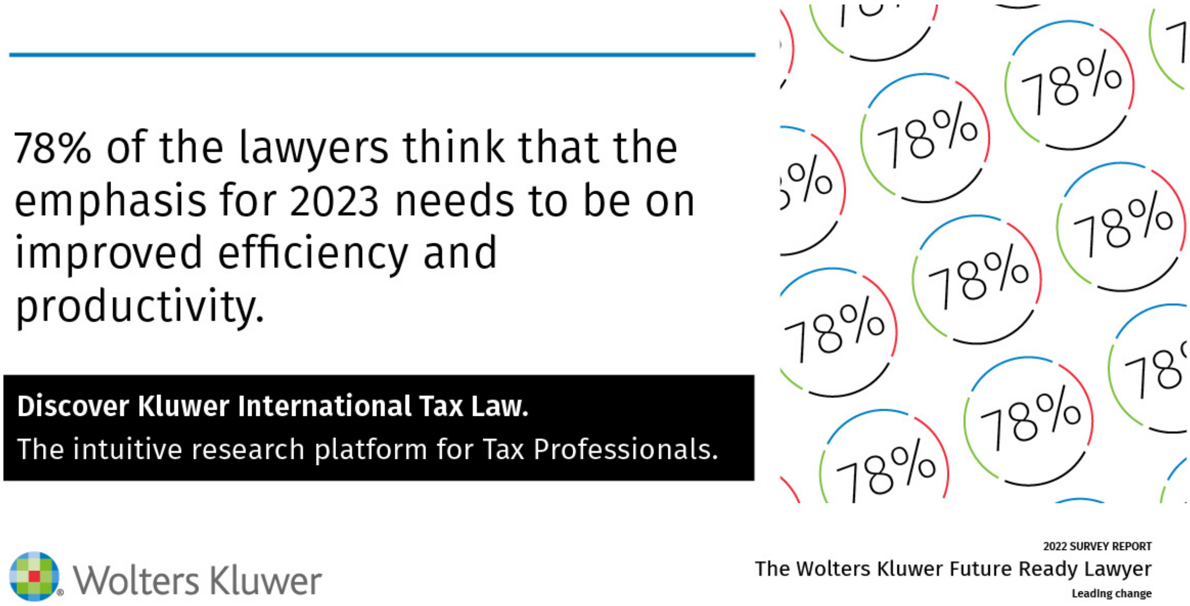

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